Co-Ownership — Getting In, Staying In And Getting Out: The Good, The Bad And The Tax!

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THIS PROGRAM IS NOT INTENDED TO PROVIDE SPECIFIC LEGAL OR ACCOUNTING ADVICE

This Program is not intended to provide the participant with specific legal or accounting advice. For solutions to legal and accounting questions, consult your attorney and/or certified public accountant.

The sequence of the Figure Numbers for this Program correspond to **Joining And Leaving the Dental Practice**, Second Edition, and **Business, Legal And Tax Planning for the Dental Practice**, Third Edition.

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Figure 9-5

—

Associate Needs Analysis

A. Assumptions

1. Associate Will Work Full-Time — 32 Hours Per Week and Will Earn the Greater of $120,000 (Includes Payroll Taxes and Benefits) Per Year or 30% of Adjusted Production, Including Hygiene Exam Fees, But Not X-Rays or Hygiene Services.
2. Assistant Will Cost $35,000 Per Year, Inclusive of Compensation, Payroll Taxes and Benefits.
3. Additional Equipment, Remodeling, Supply and Laboratory Costs, Payable Over 7 Years, Inclusive of Interest of $10,000.
4. Marketing and Advertising Costs of $10,000

B. Costs and Required Collections

1.	Associate	$ 120,000
2.	Assistant	$ 35,000
3.	Capital Expenditures, Supplies and Lab:	$ 10,000
4.	Marketing and Advertising Costs	$ 10,000
5.	Estimated Yearly Associate Cost	$ 175,000
6.	Divided by 12 Months	÷ 12
7.	Minimum Monthly Collections Before Administrative Profit	$ 14,583

C. Analysis

1. Practice Should Earn a 10 - 15% Administrative Profit On the Associate.
2. Consider Mentorship Time, New Patient Flow, Facility Use, Practice Systems, Reduction of Practice Owner's Collections.
3. How Many Active Patients Are There in the Practice?
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Example-1
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Compensation Allocation

For each consecutive month of the Employment Term, Employee shall be entitled to Basic Salary equal to: (a) the monthly collected revenues attributable to professional dental services rendered to Corporation's Patients by Employee; (b) less fifty percent (50%) of Corporation's fixed overhead expenses (prorated on a monthly basis); (c) less fifty percent (50%) of Corporation's variable overhead expenses (prorated on a monthly basis); and (d) less all direct business expenses (prorated on a monthly basis) incurred by Corporation and attributable to Employee's aforementioned professional dental services on behalf of Corporation, which monthly collected revenues, fixed expenses, variable expenses, and direct business expenses shall be determined by Corporation's accountant and approved by Corporation's Board of Directors.

Example-2
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C. Father/Mother Admits Son/Daughter as Owner After Associateship.

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Example-3
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What Do You Think?

You purchased or established your practice in 1990. You are very busy, have already relocated, have made the decision to hire an associate and are contemplating co-ownership in the future. You plan on practicing full-time for another 10 years. The associate employment agreement is prepared, the practice valuation is completed and your exit strategy is defined.

Question A.

When should the ownership agreements be prepared?

Question B.

What business and tax structure should be used?

1. Purchase and Sale of Stock in After-Tax Dollars Adjusting the Purchase Price?

2. Stock Excluding Goodwill?

3. The Three Entity Method?

4. A Solo Group Arrangement?

Figure 11-1
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Criteria for Successful Co-Ownership

1. Dr. Junior agrees to a mandatory buy-out of Dr. Senior upon retirement in accordance with a predetermined and agreed upon formula to account for future practice growth; incentives and disincentives in place to ensure that the parties live up to their obligations;

2. Practice valuation and transition memorandum are prepared as early as possible;

3. There is a "way out" or exit that is available for any owner;

4. Patient base remains separate for each owner and any associate dentist in general practices;

5. The practice is economically healthy;

6. There are sufficient new patients and growth;

7. The existing owner(s) cannot incur a drop in compensation, unless time in practice is reduced;

8. The owners are compatible with each other;

9. The economics of the associate buy-in are "fair" to both or all parties;

10. Compensation and benefits are allocated fairly;

11. Decision making control of the practice is agreed upon by both or all parties, with dispute resolution devices in place;

12. Spousal involvement in the practice is agreed upon by both or all parties in advance.

Figure 11-2

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Common Reasons Why Co-Ownership Relationships Fail

1. The economics of the associate buy-in(s) and owner buy-out(s) are incorrect and unrealistic;

2. Insufficient patients and/or referral sources;

3. Disproportionate quality of clinical treatment;

4. Disproportionate productivity;

5. Disproportionate effort;

6. Varying long-range or strategic goals;

7. Failure to discuss practice business through regularly scheduled board or owner meetings;

8. Practicing in the wrong location;

9. Inefficient facility design;

10. Inability to compromise;

11. Personality conflicts and other personality issues;

12. Ineffective management and/or delegation of management duties and responsibilities, including staff training;

13. Ineffective leadership; and/or

14. Inadequate, unrealistic, outdated or the absence of buy-in, operational and buy-out documents.

Figure 11-3
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Effect of Compensation Shift

Assumptions
Capital Gains – 20%
Ordinary Income – 40%

Per $500,000 Buy-In

Pre-Tax	**Purchaser**	**Seller**	**Total**
Purchase Price	$500,000	$500,000	$500,000
Tax Rate	N/A	40%	40%
Taxes Paid	N/A	$200,000	$200,000

Post-Tax	**Purchaser**	**Seller**	**Total**
Purchase Price	$500,000	$500,000	$500,000
Tax Rate	40%	20%	60%
Taxes Paid	$200,000	$100,000	$300,000

Per $100,000

Pre-Tax	**Purchaser**	**Seller**	**Total**
Purchase Price	$100,000	$100,000	$100,000
Tax Rate	N/A	40%	40%
Taxes Paid	N/A	$40,000	$40,000

Post-Tax	**Purchaser**	**Seller**	**Total**
Purchase Price	$100,000	$100,000	$100,000
Tax Rate	40%	20%	60%
Taxes Paid	$40,000	$20,000	$60,000

Given capital gains of 20%, inclusive of State Tax and AMT, and ordinary income rates of 40%, it costs one-third more to purchase stock in after-tax dollars than it does to reallocate compensation. This assumes that the senior doctor actually performs administrative and management services in exchange for the fees paid. **Potential Risk!**

Figure 11-4
—
Compensation Shift and Allocation

3. <u>Employee's Compensation</u>.

3.1 <u>Basic Salary</u>. For each consecutive month of the Employment Term, Corporation shall pay Employee a basic salary (herein called the "Basic Salary") equal to any other Officer/professional employee of Corporation. The Basic Salary shall be payable in at least monthly installments and prorated (on a daily basis) if the Employment Term terminates prior to the completion of any monthly period.

3.2 <u>Year-End Bonus</u>. In consideration of Employee's productivity and overall contribution to the benefit of the Corporation, Corporation shall also pay Employee a bonus (herein called the "Year-End Bonus") before the end of each Corporate fiscal year as follows:

(a) The sum of the available bonus pool, as determined by Corporation's Board of Directors;

(b) Add all Basic Salary and advance bonus payments paid to Employee and Dr. _____ for such Corporate fiscal year;

(c) Add all "unique" expenses (as herein defined) paid by Corporation on behalf of Employee and Dr. _____ for such Corporate fiscal year;

(d) Multiply the sum of (a), (b) and (c), above, times a fraction, the numerator of which is Corporation's collections attributable to Employee's rendering of professional dental services for such Corporate fiscal year, and the denominator of which is Corporation's collections attributable to Employee's and Dr. _____'s rendering of professional dental services for such Corporate fiscal year;

(e) Subtract all Basic Salary and advance bonus payments paid to Employee for such Corporate fiscal year; xx[and]xx

(f) Subtract direct business expenses attributable to Employee's employment with Corporation, which direct business expenses include; (i) dental laboratory; (ii) automobile; (iii) travel; (iv) entertainment; (v) continuing education; (vi) retirement plan contributions; and (vii) any other expenses, as determined by the Corporation's Board of Directorsxx[.]xx xx[; and]xx xx[(g) Subtract the Management Fees payable to Dr. _____ under a certain Practice Management Agreement, dated _____, 20__.]xx

The Corporation's Board of Directors may make partial advance payments of bonus from time to time during a Corporate fiscal year based upon Corporation's general cash and financial position. xx[it is determined by Corporation's Board of Directors that the Year-End Bonus is a negative amount, then such negative amount shall be treated as a cash advance by Corporation to Employee which shall be repaid through an offset against Employee's future Basic Salary; provided, however, that upon termination of this Agreement and the Agreement Term, Employee shall immediately repay the cumulative total of any outstanding cash advances. Corporation's Board of Directors may require said advances to be evidenced by a promissory note (in form and substance satisfactory to Corporation).]xx Any Year-End Bonus shall be prorated (on a monthly basis) if the Agreement Term terminated prior to the completion of any Corporate fiscal year.

Figure 11-5
—
Buy-In Methods

	Advantages	Disadvantages
1. Stock in after-tax dollars	• No tax risk • Simple and straightforward • Capital gains to seller • Basis to purchaser • Security for payment • Dr. Junior unaffected by sale of Dr. Senior's stock to a third doctor	• Expensive • After-tax dollars to purchaser • Contingent and unknown liabilities
2. Stock excluding goodwill, coupled with compensation shift Stock excluding goodwill, coupled with purchase of personal goodwill individually. *** An individual's purchase of personal goodwill in place of the compensation shift is not amortizable.**	• Inexpensive and affordable for the new owner	• Potential tax risk • Ordinary income to seller • Minimal security for payment • Second owner affected by senior owner's sale of stock to a third doctor
3. Three entity method	• Amortizable, if practice formed after August 10, 1993 • Owner flexibility in business expense allocation • Dr. Junior unaffected by Dr. Senior's sale of stock to a third doctor	• Goodwill non-amortizable, if practice formed after August 10, 1993 • Three tax returns • All employees are covered in retirement plan

Figure 11-6
—
Buy-Out Methods

	Advantages	Disadvantages
1. Stock in after-tax dollars	• No tax risk • Simple and straightforward • Capital gains to seller • Basis to purchaser • Buy-out made in cash • Dr. Junior unaffected by sale of Dr. Junior's stock to a third doctor	• Expensive • After-tax dollars to purchaser
2. Stock excluding goodwill, coupled with corporation's purchase of personal goodwill or payment of deferred compensation *** An individual's purchase of personal goodwill in place of the corporation's purchase or payment of deferred compensation is not amortizable.**	• Arguably, capital gains to seller, relative to corporation's purchase of personal goodwill • Deferred compensation inexpensive and affordable to Dr. Junior, but not as beneficial to seller as corporation's payment of personal goodwill • Buy-out paid in cash, except for deferred compensation	• Potential tax risk — low stock value / purchase and sale of personal goodwill • Cannot be subject to a restrictive covenant — little security for payment of deferred compensation
3. Three entity method	• Amortizable if the practice is formed after August 10, 1993 • Owner flexibility for business expense allocation • Dr. Junior unaffected by Dr. Senior's sale of interest to a third doctor	• Goodwill not amortizable if practice formed before August 10, 1993 • Three tax returns • All employees are covered in retirement plan

Figure 11-7
—
Potential Issues in Funding Retirement Plan Contributions With Associate Profits and Compensation Based Buy-Ins.

1. This mechanism assumes that associate buy-ins can be made as a compensation shift resulting in mostly a pre-tax buy-in. In a C-corporation, the compensation shift could be recharacterized to a non-deductible dividend.

2. The economics of the associate buy-ins are based upon future projections of growth that may or may not occur. The associate/new owner may leave the practice if the future projections of growth are incorrect.

3. What is the facility relocation cost to accommodate the new doctor? Will the existing facility allow for significant increases in revenues and profits?

4. If the retirement plan adopted is a defined benefit plan, significant contributions are mandatory, not optional.

5. Any defined benefit plan will need to be in effect for minimally three years, usually five years. What happens if contributions cannot be made?

6. Human behavior and theoretical outcomes greatly differ. Behavioral change is mandatory to change economic outcomes.

7. Profitability will affect income allocation.

8. Practice owners are being told that they can fund their retirement plan from the efforts of the associate/new owner. The associate/new owner and this individual's advisors may not share the same view.

9. Tax-qualified retirement plans are not for everyone. What about real estate and other investments outside of the retirement plan? This assumes that the doctor has the discipline to save outside of the tax-qualified retirement plan.

10. Practice management is crucial to the success of this mechanism to increase revenues and profitability on a consistent basis. Given the quality, quantity and economic cost of management training, will the doctor(s) change the practice for the better?

Figure 11-8
—
Compensation Allocation

Senior Owner

3. **Employee's Compensation.** During the Employment Term, Corporation shall allocate Employee's compensation and any bonuses (collectively the "Basic Salary") as periodically determined by Corporation's Board of Directors and as described in the "Compensation Allocation" in Schedule A, attached herein and incorporated herein by reference.

Corporation's Board of Directors may make partial advance payments of the Basic Salary from time to time during a Corporate fiscal year based upon Corporation's general cash and financial position. If it is determined by Corporation's Board of Directors that the Basic Salary is a negative amount, then such negative amount shall be treated as a cash advance by Corporation to Employee which shall be repaid through an offset against Employee's future Basic Salary; provided, however, that upon termination of this Agreement and the Agreement Term, Employee shall immediately repay the cumulative total of any outstanding cash advances. Corporation's Board of Directors may require said advances to be evidenced by a promissory note (in form and substance satisfactory to Corporation). Any Basic Salary shall be prorated (on a monthly basis) if the Agreement Term terminated prior to the completion of any Corporate fiscal year.

New Owner

3. **Employee's Compensation.** During the Employment Term, Corporation shall allocate Employee's compensation and any bonuses (collectively, the "Basic Salary") as periodically determined by Corporation's Board of Directors and as described in the "Compensation Allocation" in Schedule A, attached hereto and incorporated herein by reference. Notwithstanding the foregoing, Employee's Basic Salary shall be reduced and offset by the Management Fees payable to Dr. __________ under a certain Practice Management Agreement of even date, between Corporation and Dr. __________.

Corporation's Board of Directors may make partial advance payments of the Basic Salary from time to time during a Corporate fiscal year based upon Corporation's general cash and financial position. If it is determined by Corporation's Board of Directors that the Basic Salary is a negative amount, then such negative amount shall be treated as a cash advance by Corporation to Employee which shall be repaid through an offset against Employee's future Basic Salary; provided, however, that upon termination of this Agreement and the Agreement Term, Employee shall immediately repay the cumulative total of any outstanding cash advances. Corporation's Board of Directors may require said advances to be evidenced by a promissory note (in form and substance satisfactory to Corporation). Any Basic Salary shall be prorated (on a monthly basis) if the Agreement Term terminated prior to the completion of any Corporate fiscal year.

SCHEDULE A

Compensation Allocation

For each consecutive month of the Employment Term, Employee shall be entitled to Basic Salary equal to: (a) the monthly collected revenues attributable to professional dental services rendered to Corporation's Patients by Employee; (b) less fifty percent (50%) of Corporation's fixed overhead expenses (prorated on a monthly basis); (c) less fifty percent (50%) of Corporation's variable overhead expenses (prorated on a monthly basis); and (d) less all direct business expenses (prorated on a monthly basis) incurred by Corporation and attributable to Employee's aforementioned professional dental services on behalf of Corporation, which monthly collected revenues, fixed expenses, variable expenses, and direct business expenses shall be determined by Corporation's accountant and approved by Corporation's Board of Directors.

Figure 11-9

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Overhead Allocation Chart

Category	Practice Pays Overhead: Dr. Senior		Practice Pays Overhead: Dr. Junior		Pro Rata Overhead: Dr. Senior		Pro Rata Overhead: Dr. Junior	
1. Practice Revenue	$1.00		$1.00		$1.00		$1.00	
2. Overhead	- .6		- .6		- .6		- .6	
3. Available Compensation Percentage	.4		.4		.4		.4	
4. Doctor Revenue	x .6		x .4		.6		.4	
5. Overhead	N/A		N/A		- .3		- .3	
6. Doctor Compensation	.24		.16		.3		.1	
7. Doctor Compensation as Percentage of Available Compensation	.24 / .4	= 60%	.16 / .4	= 40%	.3 / .4	= 75%	.1 / .4	= 25%
8. Doctor Compensation as a Percentage of Practice Revenue	.24 / .6	= 40%	.16 / .4	= 40%	.3 / .6	= 50%	.1 / .4	= 25%

Over time, Dr. Junior rarely produces more than Dr. Senior. In other words, the percentages change very little over 20 years.

In a solo group, some expense categories will be equally allocated and some on the basis of productivity or collected revenue. However, each practice pays its own staff (with some sharing), supplies (except for common supplies), lab, direct business expenses, insurances and benefits.

Where the practice pays the Overhead, each owner is allocated compensation equal to the respective owner's collections, multiplied by the Available Compensation Percentage.

Figure 11-10

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Overhead Allocation Chart

Category	Practice Pays Overhead				Pro Rata Overhead			
	Dr. Senior		Dr. Junior		Dr. Senior		Dr. Junior	
1. Practice Revenue	$1.00		$1.00		$1.00		$1.00	
2. Overhead	- .6		- .6		- .6		- .6	
3. Available Compensation Percentage	.4		.4		.4		.4	
4. Doctor Revenue	x .55		x .45		.55		.45	
5. Overhead	N/A		N/A		- .3		- .3	
6. Doctor Compensation	.22		.18		.25		.15	
7. Doctor Compensation as Percentage of Available Compensation	.22 / .4	= 55%	.18 / .45	= 45%	.25 / .4	= 62.5%	.15 / .4	= 37.5%
8. Doctor Compensation as a Percentage of Practice Revenue	.22 / .55	= 40%	.18 / .45	= 40%	.25 / .55	= 45.45%	.15 / .44	= 33.3%

Figure 11-11

—

Overhead Allocation Chart

Category	Practice Pays Overhead: Dr. Senior		Practice Pays Overhead: Dr. Junior		Pro Rata Overhead: Dr. Senior		Pro Rata Overhead: Dr. Junior	
1. Practice Revenue	$1.00		$1.00		$1.00		$1.00	
2. Overhead	- .6		- .6		- .6		- .6	
3. Available Compensation Percentage	.4		.4		.4		.4	
4. Doctor Revenue	x .5		x .5		.5		.5	
5. Overhead	N/A		N/A		- .3		- .3	
6. Doctor Compensation	.2		.2		.2		.2	
7. Doctor Compensation as Percentage of Available Compensation	.2 / .4	= 50%	.2 / .4	= 50%	.2 / .4	= 50%	.2 / .4	= 50%
8. Doctor Compensation as a Percentage of Practice Revenue	.2 / .5	= 40%	.2 / .5	= 40%	.2 / .5	= 40%	.2 / .5	= 40%

Figure 11-12

—

Overhead Allocation Chart

Category	Practice Pays Overhead: Dr. Senior		Practice Pays Overhead: Dr. Junior		Pro Rata Overhead: Dr. Senior		Pro Rata Overhead: Dr. Junior	
1. Practice Revenue	$2,000,000		$2,000,000		$2,000,000		$2,000,000	
2. Overhead	-1,200,000		-1,200,000		-1,200,000		-1,200,000	
3. Available Compensation	$ 800,000		800,000		800,000		800,000	
4. Doctor Revenue	x .6		x .4		1,200,000		800,000	
5. Overhead	N/A		N/A		-600,000		-600,000	
6. Doctor Compensation	$ 480,000		320,000		600,000		200,000	
7. Doctor Compensation as Percentage of Available Compensation	$ 480,000 / $ 800,000	= 60%	320,000 / 800,000	= 40%	600,000 / 800,000	= 75%	200,000 / 800,000	= 25%
8. Doctor Compensation as a Percentage of Practice Revenue	$ 480,000 / $1,200,000	= 40%	320,000 / 800,000	= 40%	600,000 / 1,200,000	= 50%	200,000 / 800,000	= 25%

Figure 11-13

Overhead Allocation Chart

Category	Practice Pays Overhead: Dr. Senior		Practice Pays Overhead: Dr. Junior		Pro Rata Overhead: Dr. Senior		Pro Rata Overhead: Dr. Junior	
1. Practice Revenue	$2,000,000		$2,000,000		$2,000,000		$2,000,000	
2. Overhead	-1,200,000		-1,200,000		-1,200,000		-1,200,000	
3. Available Compensation	$ 800,000		800,000		800,000		800,000	
4. Doctor Revenue	x .55		x .45		1,100,000		900,000	
5. Overhead	N/A		N/A		-600,000		-600,000	
6. Doctor Compensation	$ 440,000		360,000		500,000		300,000	
7. Doctor Compensation as Percentage of Available Compensation	$ 440,000 / $ 800,000	= 55%	360,000 / 800,000	= 45%	500,000 / 800,000	= 62.5%	300,000 / 800,000	= 37.5%
8. Doctor Compensation as a Percentage of Practice Revenue	$ 440,000 / $1,100,000	= 40%	360,000 / 900,000	= 40%	500,000 / 1,100,000	= 45.45%	300,000 / 900,000	= 33.3%

Figure 11-14

—

Overhead Allocation Chart

Category	Practice Pays Overhead: Dr. Senior		Practice Pays Overhead: Dr. Junior		Pro Rata Overhead: Dr. Senior		Pro Rata Overhead: Dr. Junior	
1. Practice Revenue	$2,000,000		$2,000,000		$2,000,000		$2,000,000	
2. Overhead	-1,200,000		-1,200,000		-1,200,000		-1,200,000	
3. Available Compensation	$ 800,000		800,000		800,000		800,000	
4. Doctor Revenue	x .5		x .5		1,000,000		1,000,000	
5. Overhead	N/A		N/A		-600,000		-600,000	
6. Doctor Compensation	$ 400,000		400,000		400,000		400,000	
7. Doctor Compensation as Percentage of Available Compensation	$ 400,000	= 50%	400,000	= 50%	400,000	= 50%	400,000	= 50%
	$ 800,000		800,000		800,000		800,000	
8. Doctor Compensation as a Percentage of Practice Revenue	$ 400,000	= 40%	400,000	= 40%	400,000	= 40%	400,000	= 40%
	$1,000,000		1,000,000		1,000,000		1,000,000	

Figure 11-17
—
Buy-Sell Agreement Matrix

				Contract Terms			
				Nature of Parties' Obligations			
TRIGGERING EVENTS	Purchase Price (a)	Payment Terms (b)	Purchase of Insurance (c)	Practice/ Remaining Owner(s) Must Buy	Practice/ Remaining Owner(s) have Option to Buy	Departing Owner Must Sell	Departing Owner has Option to Sell
Death							
Permanent Disability							
Election to Transfer by Owner							
Termination of Owner's Employment							
Retirement							
Dispute							

(a) Purchase Price Options:

1. Stock In After-Tax Dollars
2. Stock Excluding Goodwill, Coupled With Corporation's Payment of Personal Goodwill or Payment of Deferred Compensation.
3. Three Entity Method

(b) Payment Term Options:

1. Cash
2. Promissory Note
3. Cash Down Payment and Promissory Note

(c) Purchase of Insurance to Fund Obligation:

1. Life Insurance
2. Disability Buy-Out Insurance

Figure 11-18

—

Schedule E

Corporate Share Value in the Event of Termination of Employment

The value of the Corporate Shares of a Terminated-Shareholder shall equal: (a) the fair market value of Corporation's dental equipment, office equipment and furniture (herein called the "Tangible Assets") determined by (i) the net book value of the Tangible Assets as of the date of purchase, plus (ii) one-third (1/3) of the depreciation previously taken by Corporation on the Tangible Assets as of the Purchase Date; plus (b) the fair market value of Corporation's dental supplies determined by (i) the sum of the dental supplies purchased by Corporation for the most recent twelve (12) months immediately preceding the Purchase Date, and (ii) divided by twelve (12) months, and (iii) multiplied by three (3) months; plus (c) the fair market value of dental instruments determined by (i) the sum of Corporation's billed and collected revenues for the most recent twelve (12) months immediately preceding the Purchase Date, and (ii) multiplied by one-half percent (1/2%); plus (d) _____________ percent (_____%) of Corporation's accounts receivable on the Purchase Date; less (e) Corporation's long-term debt on the Purchase Date; and (f) the sum of (a) through (e) multiplied by a percentage, the numerator of which is the percentage of the Corporate Shares owned by the Terminated-Shareholder, the denominator of which is the number of Corporate Shares owned by all Shareholders.

____
xx[Dr. 1]xx

____
xx[Dr. 2]xx

____
xx[Dr. 3]xx

–Shareholders–

xx[PROFESSIONAL CORPORATION]xx

By:_____________________________________
xx[Dr. 1]xx, President

And:____________________________________
xx[Dr. 2]xx, Vice-President

And:____________________________________
xx[Dr. 3]xx, Vice-President

–Corporation–

____________________, 20___

Figure 11-19
—
Schedules A, B, C, D, E

Agreed Share Value

The value of each Corporate Share of a Deceased, Disabled, Electing, Terminated or Retiring-Shareholder shall equal ________________ Dollars ($___________).

Corporate Share Values May Vary According To The Triggering Event

____
xx[Dr. 1]xx

____
xx[Dr. 2]xx

____
xx[Dr. 3]xx

–Shareholders–

xx[PROFESSIONAL CORPORATION]xx

By:_______________________________________
xx[Dr. 1]xx, President

And:______________________________________
xx[Dr. 2]xx. Vice-President

And:______________________________________
xx[Dr. 3]xx, Vice-President

–Corporation–

______________________, 20___

Figure 11-20

—

Schedules A, B, C, D

Formula Share Value In The Event Of Death, Permanent Disability, Election To Transfer, Or Retirement

The value of the Corporate Shares of a Deceased, Disabled, Electing or Retiring-Shareholder shall equal: (a) the sum of Corporation's billed and collected gross revenues for the fiscal year immediately preceding the fiscal year in which a Shareholder's Death, Disability, Election to Transfer, or Retirement occurs; (b) multiplied by ____________%; and (c) multiplied by a percentage, the numerator of which is the percentage of the Corporate Shares owned by the Deceased-Shareholder, Disabled-Shareholder, Electing-Shareholder, or Retiring-Shareholder, and the denominator of which is the number of Corporate Shares owned by all Shareholders.

Separate Schedule for Termination of Employment

____
xx[Dr. 1]xx

____
xx[Dr. 2]xx

____
xx[Dr. 3]xx

–Shareholders–

xx[PROFESSIONAL CORPORATION]xx

By:__________________________________
xx[Dr. 1]xx, President

And:_________________________________
xx[Dr. 2]xx. Vice-President

And:_________________________________
xx[Dr. 3]xx, Vice-President

–Corporation–

____________________, 20___

Figure 11-21
—
Liquidation Value

The Liquidation Value of the Company on the Valuation Date shall equal the most recent appraisal of Company's dental practice completed by __________ or any appraiser designated by the Members.

Figure 11-22

—

Ten Questions On Co-Ownership

<u>Question 1</u>.

Is the associate who acquires a 49% or 50% practice interest, the candidate who will purchase the remaining 51% or 50%?

<u>Answer 1</u>.

Probably not, and the practice owner should not elevate the associate to ownership without the incoming doctor being obligated to buy-out such owner(s) upon retirement. Retirement should be a defined term in the buy-out agreements and may include a "no later than date", e.g., age 70. If the incoming doctor will not agree to buy-out the retiring doctor, it is difficult to sell the retiring doctor's interest to a third party who must work with the remaining doctor.

<u>Question 2.</u>

If the newly admitted owner is acquiring a 49% or 50% interest of the practice for fair market or appraised value, won't he or she want equal decision making control?

<u>Answer 2</u>.

First, if the incoming owner is acquiring his or her interest for fair market value, the new owner should want to purchase an interest in the practice equal to any other owner, e.g., 50% in a two-doctor practice. Otherwise, the parties are not truly "partners". And yes, the newly admitted dentist or specialist does desire to maintain equal decision making control in the practice. However, it is rare where associate buy-ins are paid in cash as the lender requires the practice as security. Where the practice owner guarantees the new doctor's loan, the practice owner is still financing the buy-in due to the guarantee. Therefore, until the incoming owner pays for his or her interest in the practice, I do not object to decision making control remaining with the existing owner(s) until such interest is fully paid, typically in five or seven years. However, certain decisions such as hiring a new dentist or specialist or relocating the practice would require the unanimous consent of both or all owners during this period. Thereafter, decision making control can be equal, provided that appropriate dispute resolution mechanisms are contained in the agreements. Roughly 16 states have close corporation statutes, whereby decision making control can be determined by contract. These statutes are useful tools as multiple owners can be admitted and the "founder" of the practice can maintain decision making control so long as such individual retains one share of stock in the professional corporation.

<u>Question 3</u>.

Will the incoming doctor be willing to pay the fair market value of the practice interest being purchased as of the date of the buy-in?

<u>Answer 3</u>.

Probably not. The incoming doctor would prefer to have the practice value determined as of the date that the associate agreement is signed, as opposed to the completion of the associate period, e.g., after three years. Therefore, the practice owner should not interview any associate until his or her succession plan is prepared and the practice valued. Preparation of a succession plan includes delineating the tax and business structure of leaving the practice and may include admitting a new owner or selling the practice in its entirety at some point. I prefer to prepare all ownership agreements prior to the new doctor commencing employment so that significant issues are not raised at a later date. Minimally, I would want the practice valuation completed, the associate employment agreement prepared and a letter of intent outlining the future ownership. An exception to this would be where the associate relationship is permanent and will not lead to future ownership. The succession plan will be applicable irrespective of the identity of the associate/candidate. What seems to be a workable solution is to revalue the practice after predetermined performance and quality standards are consistently met by the associate being elevated to ownership. New patients brought to the practice by or collections attributable to the associate are measured and the goodwill is correspondingly reduced. This should be distinguished with the solo group arrangement, whereby the associate buys the goodwill attributable to his or her developing patient base. Not dealing with the future working relationship in advance usually leads to disagreements and misunderstandings at the time ownership is offered.

<u>Question 4</u>.

What steps should the new doctor take prior to commencing employment if co-ownership is contemplated?

<u>Answer 4</u>.

The new doctor should determine, both qualitatively and quantitatively, what he or she wants in a practice, rather than entering into an associateship just to have a job. Assuming that the vision and objectives of both parties are the same or substantially similar, the new doctor should sign a confidentiality letter and commence the due diligence or purchaser "homework" investigation prior to commencing employment. Unfortunately, this significant step is often overlooked by both parties as the practice owner should complete his or her due diligence investigation of the incoming doctor/candidate.

<u>Question 5</u>.

What recourse does a practice owner have in the event that the new owner does not perform as expected or if the parties just cannot work with each other?

<u>Answer 5</u>.

Ownership in dental and dental specialty practices may be offered earlier than is appropriate, e.g., three years, rather than requiring the associate to attain predetermined quality and productivity standards. As a result, the parties can end up in a dispute where expectations differ. Thus, the newly admitted owner's employment agreement may include a "termination by notice" provision and the buy-out agreements would specify who stays and who leaves the premises in the event of a dispute. Obviously, if the existing practice owner terminates the ownership without cause, the newly admitted owner would be bought out for full fair market value, provided that the departing new owner complies with the restrictive covenant provisions contained in the buy-out agreements. As an alternative, the buy-out agreements may provide that the newly admitted owner can elect to be bought out for the pro rata value of the tangible assets of the practice only, less any amount(s) owed to the practice owner(s), and retain the charts of those patients customarily treated by such newly admitted owner. This assumes that the new owner has paid for the goodwill attributable to his or her patient base within the practice. And yes, each doctor's patients should remain separate. In this case, the departing doctor would be permitted to practice within the restricted area, but not solicit other patients of the practice or its employees, except perhaps for his or her assistant. While this issue is more complex in specialty practices because patients and referral sources will probably not be separate, it is solvable.

Question 6.

What if the newly admitted owner does not honor his or her obligation to purchase the retiring owner's interest in the practice?

Answer 6.

If the newly admitted owner does not honor his or her obligation to buy-out the retiring owner, there would be a breach of contract claim by the retiring doctor against the remaining doctor. Additionally, the owner and buy-out agreements would provide that the employment of this owner would terminate and such breaching owner would receive very little for his or her interest in the practice. The agreements would further provide that the restrictive covenants would remain in effect. Thereafter, the retiring dentist or specialist would search for a new candidate to purchase the practice in its entirety.

Question 7.

Should family members and spouses be permitted to work in the practice?

Answer 7.

Some of the best run practices employ non-doctor family members as administrators. These relationships should be identified and dealt with at the time that the co-ownership relationship is structured, hopefully prior to the associate picking up a "handpiece". From my experience, some of the most difficult spouses in the practice are males who function as office administrators. However, this is only a generalization. If the spouse works in the practice, the compensation should be the fair market value of such services, as opposed to a lower value, which is often the case. A very positive reason to employ the non-doctor spouse(s) is to obtain the favorable retirement plan contributions, e.g., a safe harbor 401(k) profit-sharing plan.

<u>Question 8</u>.

How should the owners allocate compensation and benefits?

<u>Answer 8</u>.

Compensation and benefits are typically allocated in one of four ways by: (1) the respective collections of one owner as a percentage of the collections of all owners; (2) ownership percentage; (3) the administrative and management duties performed by one owner and not the other(s); or (4) a combination of these methods. Where compensation is allocated by respective collections or production, certain expenses, e.g., occupancy costs, may be allocated equally and this should be defined in the respective employment agreements, the limited liability company operating agreement or partnership agreement. If one owner does not desire to participate in the retirement plan, a bad idea, such owner can be written out of the plan and admitted at a later date. Those expenses and benefits that are disproportionate among the owners can be fairly allocated under the compensation formula. An example of this may be an automobile expense, continuing education and travel or dental laboratory costs. It should be noted that compensation based upon respective collections or production is relatively uncommon for a specialist, especially orthodontists and pediatric dentists.

<u>Question 9</u>.

Are owner buy-outs paid for over time and is there a risk of default?

<u>Answer 9</u>.

Yes, because the goodwill portion of the buy-out will be deferred compensation and paid over time. Buy-outs of personal goodwill are very problematic.

<u>Question 10</u>.

How are buy-outs handled when two or more owners are roughly the same age?

<u>Answer 10</u>.

When two or more owners are roughly the same age, it is difficult, although this is a generalization, to continue co-ownership with two or more new doctors in place of the retiring doctors. What does work well, however, is to split the practice into two separate entities as a solo group and sell each practice separately. The respective purchasers obtain the benefit of sharing expenses in one facility, assuming they chose to do so.

Example 1
—
Corporate Division

Dr. Smith and Dr. Jones have practiced for 10 years as shareholders in their dental specialty practice and no longer desire to practice with each other due to production disparities. Drs. Smith and Jones meet the requirements under Section 355 of the Tax Code to implement a corporate division of their C-corporation. The doctors have one practice facility and after negotiations, it was decided that Dr. Jones would relocate Dr. Jones' practice to another location and Dr. Smith would retain the existing facility. In exchange for Dr. Jones' shares of stock, Dr. Jones will form a new corporation and will receive half of the assets of the C-corporation that Dr. Smith will retain, plus a specified sum of cash for the budgeted cost of relocation.

Considerations:

1. Number of Locations.
2. General or Specialty Practice?
3. Are Section 355 Requirements Met?
4. Real Estate.
5. Separate Patient Base for Each Shareholder in a General Practice.
6. A Real Nice Letter to Patients/Referral Sources.
7. Who Stays/Who Relocates?
8. The Alternative Is a Court Ordered Dissolution.
9. Debt.

XIV. SOLO GROUP ARRANGEMENTS AND MERGERS.

A. Solo Group Arrangements As An Alternative To Co-Ownership.

1. Amortization of Goodwill Permitted, Except for Family Members.

2. Usually, No Mandatory Buy-Out.

3. Sharing of Staff Permitted.

4. Separate Retirement Plans Permitted.

5. Usually Not for Dental Specialists.

B. Mergers.

1. Always Look.

2. What to Charge and How?

3. Is This a Later Mandatory Buy-Out?

4. What If You Don't Like Each Other?

5. Who Stays, Who Goes?

- Figure 12-1 — Solo Group Arrangements Office Sharing Agreement Provisions

Figure 12-1

—

Solo Group Arrangements / Office Sharing Agreement Provisions

1. Management of the facility, decision making procedures, and dispute resolution provisions.

2. Work schedules and use of the facility.

3. Joint and individual checking accounts.

4. Division of expenses either shared equally or based upon respective practice productivity.

5. Facility maintenance.

6. Equipment repair.

7. Sharing of certain staff members as well as payment of staff compensation, fringe benefits and retirement plan contributions.

8. Confidentiality of patient records and/or referral sources.

9. Use of telephone lines.

10. Mutual indemnification or hold harmless provisions.

11. Maintenance of current license to practice the doctor's profession.

12. Responsibility for repair of the premises other than equipment.

13. Capital and cash contributions.

14. Requirements to sublet or assign space, as well as the process to hire or engage an associate doctor.

15. Termination provisions.

16. Miscellaneous provisions, e.g., an integration clause whereby the document contains the entire agreement relative to the subject matter, possible arbitration in the event of a dispute, jurisdiction and venue provisions, changes to the agreement must be in writing.

17. Maintenance of malpractice/liability insurance with specific coverage limits.

18. Any individual or entity who or which acquires the practice of a retiring or departing practice owner may be required to become a party to the Office Sharing Agreement as a condition to the practice sale.

19. The dates, time and place of respective practice owner meetings to discuss common agenda items and business.

20. Real Estate and Lease commitments — who stays and who leaves in the event of a dispute.

XV. DISPUTE RESOLUTION – FINDING MIDDLE GROUND

A. Board/Member Meetings.

B. Annual Meetings.

C. Close Corporation Agreements.

D. Third Party Arbitrator.

E. Corporate Division.

F. Dissolution.

G. "Russian Roulette" Provisions.

H. Termination of Dr. Junior's Employment With Disincentive.

I. Buy-Sell Agreements.

   1. Who Stays, Who Leaves?

   2. May Depend Upon Age.

   3. Pay for Half, You Can Compete.

J. Litigation. Emotional, Costly and Lengthy — The Last Alternative!

XVI. MAINTAINING YOUR PRACTICE ENTITY

A. Liability Protection and the Practice Entity.

B. If C-Corporation, Should We Elect S-Status?

C. The Practice Versus Real Estate.

D. Corporate / Entity Maintenance.

- Figure 16-5 — For-Profit Year End Matter Information Sheet

Figure 16-5
—
For-Profit Year-End Matter Information Sheet

NAME OF CORPORATION ________John Smith, D.D.S., Inc.________ **FISCAL YEAR ENDING** ____December 31, 20__

CLIENT NO. __________9999.001__________

_____ **(A)** **DIVIDENDS:** Date Declared:____________________ Amount Per Share: $____________________

Date Paid:____________________ Total Amount Paid: $____________________

_____ **(B)** **PROFIT-SHARING:** Total Amount (or percentage) contributed to Plan: $__________ %____________________

_____ **(C)** **TOTAL COMPENSATION** (Basic Salary PLUS all bonuses) paid to **key, management employees** (Shareholders, Directors, Officers) during the fiscal year:

Name of Employee	**Basic Salary (According to Employment Agreement)**	**TOTAL Bonuses Paid***	**If Accrual Basis Taxpayer, TOTAL Bonuses Accrued**	**TOTAL COMPENSATION**
	$	$	$	$
	$	$	$	$
	$	$	$	$
	$	$	$	$
	$	$	$	$

***Please also list bonuses in Item (D), below:**

_____ **(D)** **BONUSES: All other employees.** (Please attach additional sheets, if necessary)

Name of Employee	**Bonus Paid**	**Date Paid**	**Bonus Accrued**	**Date Accrued**	**Was this a Holiday Season Bonus?**
	$				No ____ Yes____
	$				No ____ Yes____
	$				No ____ Yes____
	$				No ____ Yes____
	$				No ____ Yes____

_____ **(E)** **SALARY INCREASES:**

Name of Employee	**Effective Date**	**Old Salary**	**New Salary**
		$	$
		$	$
		$	$
		$	$
		$	$

_____ **(F)** **MAJOR CORPORATE CAPITAL EXPENDITURES:** (Over $5,000.00):**

Item	**Date Purchased**	**Cost**
____________________	____________________	$____________
____________________	____________________	$____________
____________________	____________________	$____________
____________________	____________________	$____________

**(Note — If item purchased/sold was an automobile, list whether it was (a) purchased, or (b) sold, total purchase/sale price, date purchased/sold, year and make of car, indicate if car is for Corporate use only (or the particular person that will be using car) and give details (if applicable) for financing, (e.g., financing institution, amount borrowed, date borrowed, interest rate and payment schedule).

____

____

____

____

_____ **(G)** **SEMINARS AND CONVENTIONS ATTENDED:**

Date Attended	**Date Expenses PAID**	**Place**	**Subject**	**Attendees**
__________	__________	__________	__________	__________
__________	__________	__________	__________	__________
__________	__________	__________	__________	__________
__________	__________	__________	__________	__________

_____ **(H)** **MISCELLANEOUS TRANSACTIONS** (e.g., institution of benefit plans (e.g. Medical, Group-Term Life, Disability, Employee Expense Reimbursement Accountability), real estate or equipment leases, amendments to the Articles of Incorporation or Regulations, fiscal year changes, statutory agent changes, change of business address, charitable contributions, directors' fees, membership dues, reimbursement of expenses, etc.) Please give important details (e.g. date, amounts, etc.).

____

____

____

____

_____ **(I)** **Management Fees Paid In Exchange For Management Services Rendered.**

_____ **(J)** **No change in Officers and/or Directors (check if applicable).**

_____ **(K)** **If (I), above, not checked, then please list Officers and/or Directors.**

President:____________________ Secretary:____________________

Vice-President:____________________ Treasurer:____________________

Vice-President:____________________ Other (if any):____________________

Directors:____

____

____

XVII. SUMMARY AND THOUGHTS

A. **Start Planning Early** — Understand Your Exit Choices and Leave on Your Terms.

B. **Complete Sale** — Simple, You Receive Mostly Capital Gains and the Purchaser Can Deduct the Purchase Price.

C. **Hire Associate With Later Sale** — Avoids Complexities of Co-Ownership and Perfect for Large or Unique Practices that Require Purchaser Mentorship. Good For Seven Years Out; Sell in Three, Work for Four, or Vice-Versa.

D. **Co-Ownership** — Works Only Where Dr. Junior Commits to Purchasing the Second Half of Your Practice or Large Practices Already in Co-Ownership. Good For More Than Seven Years Out.

E. **More Than Two Doctor Practices** — Buy-Outs Are Usually Not Paid in Cash.

F. **Solo Groups** — Good Alternative to Co-Ownership Because There is No Mandatory Buy-Out of the Second Half of Your Practice.

G. **Mergers** — Mostly Contingent Sales and Works Well For Practices Not Otherwise Salable. Can Increase a New Owner's Production.

H. **Work One or Two More Years, Then Close the Doors** — This Has Merit and a Good Economic Outcome in Certain Situations.

Do Not Take Unnecessary Tax Risks,
Get Bought Out In Cash and Don't Forget Your Other Partner — the IRS!